THE CANADIAN BANKING SYSTEM AND ITS OPERATION UNDER STRESS[1]

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A. Introduction

Financially Canada is part of the United States. Fully half the gold reserve upon which its credit system is based is lodged in the vaults of the New York Clearing House. In any emergency requiring additional capital Montreal, Toronto, and Winnipeg call on New York for funds just as do St. Paul, Kansas City, and New Orleans. New York exchange is a current and universal medium in Canada and is in constant demand among the banks. A Canadian wishing to invest in securities that may be quickly marketed commonly turns to the New York market for stocks and bonds. Yet the American banker visiting in Canada, if he is unacquainted with the history of banking in his own country, finds himself in a land of financial novelties, for Canada has a banking system unlike any in operation in the United States at the present time. Twenty-nine banks, known as the "chartered banks," transact all the banking business of the Dominion. They have 2,200 branches, and each may establish new branches without increase of its capital stock. They issue notes without depositing security with the government and in such abundance that no other form of currency in denominations of $5 and above is in circulation. Notwithstanding the fact that the notes are "unsecured," their "goodness" is unquestioned among the Canadian people.

But to the student of the history of banking in the United States there is little that is radically new in the Canadian system. He finds in it many of the practices and expedients that were found excellent in the United States in the first half of the nineteenth century, and is almost persuaded that but for the Civil War what is

[1]This paper is taken, with the consent of the author, from a recent report on "The Canadian Banking System," prepared by Professor Johnson for the "National Monetary Commission." The report has just been published by the commission.

now known as the Canadian banking system would everywhere be called the American system.

The fiscal exigencies of war, which have caused changes in the banking systems of most countries, have had no influence upon the development of banking in Canada. During the first half of the nineteenth century the commercial and financial interests of Canada and the United States were comparatively intimate and the financial institutions of both countries developed on similar lines. The safety-fund system, first introduced in the State of New York in 1829, found favor also in Canada and is still an integral part of the Canadian banking system. Branch banking, which was most successfully illustrated in this country by the Bank of Indiana, and which now exists in some form or other in almost all countries except the United States, has always prevailed in Canada. The importance of a prompt redemption of bank notes as exemplified in the old Suffolk banking system in New England before the war, was fully realized in Canada and is probably better illustrated in the present Canadian system than in any other country. There bank notes and bank checks are treated as identical in nature, both being cleared with the same regularity and promptness. The so-called free banking system, which was first adopted in the State of New York in 1839 and thereafter adopted by eighteen other states of the Union, was tried in Canada in the fifties, but not on a large scale. This system, requiring that issues of bank notes should be secured by a segregated deposit of certain classes of stocks and bonds, has never met with approval among the leading bankers of Canada.

The Canadian system is a product of evolution. It has taken its present form because of the commercial and financial needs of the Canadian people. It was not created by lawyers or statesmen to meet a fiscal need of the government, but has grown up gradually under the fostering care of experienced bankers, no changes having been made until experience proved them necessary or advisable. The business interests of the Dominion, through their representatives in the provincial legislatures and in the Dominion Parliament, have had much to do with its development in a natural effort to protect the rights of the borrower, the depositor, and the note holder. The banks do not possess all the privileges many of the bankers would like to have, nor do the business men of Canada believe in the real necessity for all the protection given to the banks

by the law, yet in the main the system is satisfactory both to bankers and to their customers.

The chartered banks transact the business which in the United States is divided among national banks, trust companies, private banks, and savings banks. They buy and sell commercial paper, discount the notes of their customers, lend money on stocks and bonds, make advances to farmers, and sometimes aid in the financing of railroads and industrial enterprises. To a Canadian the word "bank" means one of the twenty-nine "chartered banks," for the law prohibits the use of the word "bank" by any other institution.

Monetary System

Canada's monetary system is substantially the same as that of the United States. The unit is the dollar of 23.22 grains of pure gold. The gold coins of the United States are legal tender in Canada. So is the British sovereign, which is rated at 4.86^{2}/_{3}$. Until recently all Canadian coins were minted in either England or the United States, but in 1908 a branch of the British mint was established in Ottawa.

The paper currency of Canada consists of Dominion notes and bank notes. The former are issued by the government under authority of the "Dominion notes act," which permits an unlimited issue, requiring security as follows: That for $30,000,000 of the notes outstanding the minister of finance shall hold in gold and government securities a reserve equal to twenty-five per cent of the issue, the amount held in gold to be not less than fifteen per cent of the amount of notes outstanding; and that against all notes issued in excess of $30,000,000 the minister shall hold an equal amount of gold. The framers of the act evidently had in mind the limitation placed upon the Bank of England's issue of notes by the Peel act of 1844. The Dominion notes, accordingly, are gold certificates rather than credit notes. The minister of finance is required to redeem the notes in gold at branches of his department in several different cities. If need be, the minister may sell bonds to obtain gold for use in the redemption of the notes.

Dominion notes are legal tender and may be issued in any denominations, but experience has proved that they are most needed in bills of large denominations for use in banking reserves and in the form of $1 and $2 bills, the banks not being permitted to issue

notes under \$5. The average circulation of Dominion notes in 1908 amounted to \$68,602,944, of which amount \$52,882,708 was in \$500, \$1,000 and \$5,000 bills, and \$14,910,365 in \$1 and \$2 bills. There has been a pretty constant increase in the amount of Dominion notes outstanding. In 1900 the total was only \$26,550,465. The bills of large denominations are practically all carried by the banks in their reserves.

Canadian banks are not permitted to issue notes of a denomination less than \$5. Of fives and multiples thereof they may issue an amount equal to their paid-up capital without deposit of security and without payment of tax. As a result the currency in the hands of the people consists almost exclusively of bank notes. The amount in circulation increased from \$50,000,000 in 1900 to \$81,400,000 in 1909.

B. Essentials of the Canadian Banking System

A chartered bank in Canada is a bank of branches, not a bank with branches. The parent bank, technically known as the "head office," neither takes deposits nor lends money. All the banking business is done by the branches, each enjoying considerable independence, but all subject to the supervision and control of the head office. The law places no restrictions upon the number or location of branches. Canadian banks, therefore, have branches in foreign countries as well as in Canada.

The general bank act, under the terms of which every bank obtains and holds its charter, is subject to revision every ten years. In its present form it is substantially as passed in 1890.

Process of Incorporation

The provisions of the bank act with respect to the organization of new banks are intended to guard against the entry of unfit or inexperienced persons into the banking business. The minimum required capital of a bank is \$500,000, of which all must be subscribed and one-half paid in before a new bank can open. At least five men of integrity and good financial standing must agree to act as provisional directors and secure a favorable report on their project from the parliamentary committee on banking and commerce. These men must agree to subscribe for fairly large blocks of stock, otherwise the committee will be inclined to reject their

application. They must convince the committee that their project is a well-considered one, that there is need for the new bank, that it is a bona fide enterprise, that they have in mind a competent man for general manager, that they really intend and expect to do a legitimate banking business. If they satisfy the parliamentary committee it will be granted. The bank, however, can not yet begin business. Provisional directors now have merely the right to advertise and cause stock books to be opened. If inside of one year capital stock to the amount of $500,000 has been subscribed and $250,000 thereof paid in, the provisional directors may call a meeting of the shareholders, at which a board of regular directors shall be chosen. Before this meeting is held at least $250,000 in cash must be paid over to the minister of finance. The regular directors must then apply to a body known as the treasury board[2] for a certificate permitting the bank to issue notes[3] and begin business and the treasury board may refuse this certificate unless it is entirely satisfied that all the requirements of the law have been met.

Having obtained its charter, a new bank must open its head office in the place designated, and may then proceed to establish branches or agencies, upon the number and location of which the law places no restriction. Under its charter it has authority to do a general banking business; it may discount commercial paper, lend money on collateral security, accept deposits payable on demand or after notice, and issue circulating notes up to the amount of its unimpaired paid-up capital in denominations of $5 and multiples thereof. An amendment of the bank act passed July 20, 1908, gives the bank the right to issue what may be called an emergency circulation during the crop-moving season (October 1 to January 31). During this period the legal maximum of the circulation of a bank is its paid-up capital plus fifteen per cent of its combined paid-up capital and surplus or rest fund. The emergency circula-

[2]The treasury board consists of the minister of finance and five ministers nominated from time to time by the governor in council. The minister of finance is chairman of the board and the deputy minister of finance ex officio the secretary.

[3]The designing and engraving of the notes is left with the bank itself. Many of the banks have had their notes made in the United States, but a bank-note company has been established in Canada and is getting a larger proportion of this business every year. The notes must bear the signatures of two officers of the bank. The authority to sign, however, may be delegated to subordinates. When notes are shipped by the head office to a branch they are usually sent with only one signature, the other being supplied by one of the branch offices. If the notes should be lost or stolen en route they are worthless.

tion, which consists of notes in form and in other respects exactly like the regular issues, is subject to a tax at a rate not to exceed five per cent per annum, the rate being fixed by the governor in council. If a bank's circulation does not exceed its paid-up capital, it pays no tax.

Security and Redemption of Notes

The law is silent on several subjects that seem of great importance to most bankers in the United States. For instance, it does not require that the banks shall deposit with a government official, or in any way set aside any kind of security for the protection of the note holder. It does not even require that the banks shall carry a cash reserve against either notes or deposits, nor does the law make the notes a legal tender for any payment. A bank need not accept the notes of other banks. The government does not guarantee the redemption of the notes. Neither does it bind itself to receive them in payment of dues to itself.

Nevertheless the notes of the Canadian banks are everywhere acceptable at par, the people apparently not being at all concerned about their "goodness." And their confidence in the note has been well justified, for nobody since 1890 has lost a dollar through the failure of a bank to redeem its notes. Following are the legal requirements, which for twenty years have proved adequate protection for the note holder:

1. Every bank must redeem its notes at its head office and in such commercial centers as are designated by the treasury board. The redemption cities are the same for all the banks. They are Toronto, Montreal, Halifax, Winnipeg, Victoria, St. John, and Charlottetown.

2. Each bank must keep on deposit with the minister of finance a sum of lawful money (gold or Dominion notes) equal to five per cent of its average circulation; the total so deposited is called the "circulation redemption fund." It is a guaranty or insurance fund for use, if need be, in the redemption of the notes of failed banks.

3. Bank notes possess first lien upon the assets of a bank.

4. Bank stockholders are liable to an assessment equal to the par value of their stock.

5. A bank must make to the minister of finance on or before the fifteenth of each month a detailed statement of its assets and liabilities on the last business day of the preceding month. This monthly

return, the form for which is set forth in the act, must be signed by three general officers.

6. The Canadian Bankers' Association, an incorporated body of which each bank is a member, is given supervision by the bank act of the issue and cancellation of notes and of the affairs of a failed bank.

7. The notes of a failed bank draw interest at five per cent from the date fixed for their redemption by the minister of finance, who may redeem them out of the assets of the bank or out of the "circulation redemption fund."

Importance of Redemption

Each of these provisions of the law has its value and significance, but only the first is absolutely essential to the successful operation of the system. All the other provisions might be changed or abolished without impairment of the efficiency of the banking system. But the abolishment of this redemption system would at once give Canada a new banking system. The bank note is almost the sole circulating medium in Canada, and the people have confidence in it because it is tested every day at the clearing houses and proves itself as good as gold. This daily test would probably not take place with the same regularity as now if the banks did not have branches or if they were obliged to deposit security against their issues. Canadian banks are national, not local institutions. All but a few of them have branches in every part of the Dominion, and these branches, as fast as they receive the notes of other banks, either send them in to the nearest redemption center or convert them into lawful money—or its equivalent, a bill of exchange—through branches of the issuing banks located in the same towns. The twenty-nine chartered banks have 2,200 branches and each bank is seeking, through its branches, to satisfy all the legitimate needs of the people for a circulating medium. When the note of a bank is in circulation it is earning money for the bank, but when it is in the vault or on the counter of the bank it is an idle and useless piece of paper. Hence every bank always pays out its own notes through its branches and sends the notes of other banks in for redemption, thus increasing its own circulation and strengthening its own reserve.

Furthermore, if the banks were not allowed complete freedom

of issue within the prescribed limit, but were required to deposit some form of security, as is required of the national banks in the United States, an investment or speculative risk would arise that would inevitably cause friction. If bonds were designated as security, bankers might often be tempted by high prices to sell their bonds and forego the profit on circulation for the sake of making a larger profit by the sale of the security. Thus the volume of bank notes might contract even at a time when the people needed more currency. In such case, of course, Canada would be obliged to import gold in order to fill the gap in the circulating medium.

The Circulation Redemption Fund

The five per cent insurance fund for the redemption of the notes of failed banks is theoretically an important and prominent part of the system, yet practically it would seem to be of little consequence, for not once since 1890 has it been necessary to use a dollar of the fund. Banks have failed, to be sure, but the notes of these banks have always been redeemed either out of the assets or by recourse to the double liability of the shareholders. It is a mistake to suppose that the people of Canada have confidence in bank notes because of the existence of this redemption fund. The average business man knows nothing about the fund and if his attention were called to it as being a source of security for the bank notes he would probably think a five per cent reserve altogether too small. The real reason why the people have faith in bank notes is because the notes are always honored by the banks and never fail to stand the test of the clearing house. In other words, they believe that bank notes are good for about the same reason that they believe the sun will rise in the east every twenty-four hours and do not bother themselves about reasons.

Nevertheless this redemption fund does contribute to the strength of the banking system. It makes each bank to a certain extent liable for the mistakes of other banks, and as a result gives rise to a spirit of mutual watchfulness and helpfulness. Other features of the system contribute to the same result, especially the fact that a Canadian bank accepts from a depositor without indorsement the notes of other banks. Since the banks have branches in agricultural and mining communities, often distant from the railroad by several days' journey, and these branches are accepting the notes

of other banks and giving credit for them as if they were gold itself, it is evidently important that each banker should have all possible information with regard to the status and business of his competitors. As a result one finds among the bankers of Canada a surprisingly intimate knowledge of each other's affairs.

Two Negative Qualities

The two negative qualities of the Canadian bank note—its lack of a legal-tender quality and of a government guaranty—at first sight may seem to readers in the United States a source of weakness. Yet Canadian bankers would doubtless all agree that nothing would be gained by making bank notes legal tender for any kind of payment or by making the government in any measure liable for their ultimate redemption. Such measures would probably be rejected as likely to prove harmful. It would be like hampering a flying machine with unnecessary bars of steel. Bank notes, like bank checks, are mere promises to pay money and are more convenient than money because they can be created as need for a medium of exchange arises. When either has done the work that called it into existence, it should disappear from circulation and be redeemed. If it is made a legal tender like money itself, or if its redemption is guaranteed by a strong government, there is always the danger that ignorant classes of people will regard it as money itself and withdraw it from circulation.

The Canadian government has nothing to do with the daily redemption of bank notes and does not guarantee that they shall be redeemed. It is custodian of the five per cent redemption fund and is under obligation to redeem the notes of failed banks out of this fund, but if a series of bank failures should exhaust it the note holder has no guaranty that government funds will be used for his relief.[4]

The possession by the note holder of a first lien upon the assets of a bank, including the funds that may be collected from shareholders on account of their double liability, gives rise to such general confidence in the ultimate convertibility of a bank note that the notes of a failed bank, on account of the interest they bear, sometimes command a premium. As a rule, the notes of such a bank are col-

[4]Bank act, section 65: (6) Nothing herein contained shall be construed to impose any liability upon the government of Canada, or upon the minister, beyond the amount available from time to time out of the circulation fund.

lected by the other banks and held until the date of redemption has been named by the minister of finance.

Management of Failed Banks

If a Canadian bank fails to meet any of its liabilities as they accrue, it forfeits at once its right of independent management and is taken charge of by a "curator" appointed by the Canadian Bankers' Association.

If the curator within ninety days is able to restore the solvency of the bank so that it is able to resume payments, it may resume business; otherwise the bank may be "wound up" and its charter revoked. During the first three months of a bank's suspension the stockholders have a chance to raise funds and restore the bank to solvency. If they fail, the curator then gives place to an official called a liquidator, who is appointed by the courts. Under a curator the stockholders still have hope and opportunity; under the liquidator the creditors of the bank are in the saddle.

The liquidator must first of all attend to the notes in circulation, their lien upon the assets being prior to all others. Inasmuch as the notes bear interest at five per cent from the date of suspension, the other banks are perfectly willing to hold them in their vaults until such a date as the liquidator names for their final redemption, all feeling certain that the notes will sooner or later be paid, for if the assets of the failed bank should prove inadequate, the mutual guaranty fund in the possession of the government will be drawn upon.

Next to the notes the deposits of the Dominion government have a prior lien, and then the deposits of provincial governments. If the assets of the bank are not sufficient to satisfy all the claims, the stockholders are liable to an assessment equal in amount to the amount of capital stock to which they subscribed plus any portion thereof which has not been paid up. Thus if a stockholder has subscribed for fifty shares of stock, par value $100, and has paid in only $2,500, he is liable to an assessment of $7,500, of which $2,500 is on account of the unpaid subscription and $5,000 is on account of the double liability.

Monthly Returns to the Government

The law provides for no publicity with regard to bank affairs beyond the returns to the minister of finance. The minister of

finance may call for supplementary information or "special returns from any bank whenever in his judgment they are necessary to afford a full and complete knowledge of its condition." The law, however, gives him no right of examination, and the government maintains no inspecting force.

Canadian Bankers' Association

The Canadian Bankers' Association is an incorporated body with powers and duties prescribed in an amendment to the bank act passed in 1900. Each chartered bank is represented in the membership and has one vote. The association is required by law to supervise the issue of bank notes and to report to the government all overissues, to look after the destruction of worn and mutilated notes, and to take charge of suspended banks. Its headquarters are in Montreal in the Bank of Montreal building, and its active executive officer is the secretary-treasurer. The expenses of the association are apportioned among the banks and do not apparently constitute a very heavy burden, for the secretary has an exceedingly small staff. All expenses incurred by the association on account of a suspended bank are, of course, a charge against the assets of the bank.

When the notes of a bank are so worn or mutilated that it wishes to replace them with new notes, notice is sent to the secretary of the association, a date is fixed, and in the presence of the secretary the old notes are duly counted and taken to a furnace, where they are consumed in the presence of the secretary and other witnesses. After this solemn operation has been performed and the signatures of all parties observing it have been duly attested, new notes are issued by the association to replace those that have been destroyed. The clearing houses in the Dominion are subject to regulation by the association.

C. The System in Time of Stress

Since the present system of banking was perfected in 1890, Canada has had no banking panic. She has suffered from periods of depression and hard times, caused either by short crops or by the failure of outside markets to absorb her produce at satisfactory prices, but never from scarcity of currency, from runs upon banks, from business failures, or from the inability of banks to meet their

obligations. It is impossible to escape the conclusion that the credit for Canada's immunity from panic and financial distress is mainly due to the character of her banking system.

No country can expect to be free from periods of dullness, no matter how perfect its banking system. International relations in trade and finance are so close that all countries suffer from the mistakes made by any one. Canada has depended very much upon English capital. She is relatively a large consumer of the products of the United States and has many an enterprise which owes its inception to American initiative. Hard times in England or in the United States must inevitably affect Canadian business. She is borrowing from England as this country did a century ago. Her credit system rests upon the gold reserves of London and New York. Under these circumstances, when one recalls how the credit and financial system of England and the United States have been shaken during the last twenty years, it is remarkable that Canada has escaped serious damage.

Strong Because Elastic

Canada's banking system contains two features that give it great strength under the threat of panic or crises. One is the elasticity of the note circulation, the other the solidarity or unity of the system. The reason why Canada has never suffered from a currency panic lies on the surface. The banks always have cash enough to meet the demands of their depositors. Instead of being in the position of their brethren across the border, that is, anxious to conserve their cash, they welcome any legitimate opportunity for the increase of their circulation. Except for a few weeks during the panic period of 1907, when practically all the banks of the United States had suspended cash payments, the Canadian banks have always had currency on hand in excess of their customers' needs. This currency consisted of their own notes. To their customers the bank notes are perfectly good money. Even though people got suspicious of the solvency of a Canadian bank, its notes would not be in disfavor.

Furthermore, when Canadian banks satisfy their customers' demands for cash, their resources are unimpaired. They are not obliged, as are the banks of the United States, to call loans in order to make good their cash reserve. With the public their notes

have all the efficiency of gold itself, and the fact that they are paid out so willingly by the bankers, the supply as a rule seeming inexhaustible, prevents anything like a panic starting among the people.

The elasticity of the note issue, however is not the most important factor contributing to the peace and security of the Canadian financial system. It must be regarded, indeed, as an essential factor, for without it the banks would be unable to maintain equilibrium without resorting to methods that at times would be perilous. If in any emergency they were obliged to raise their rates of interest and to seek to increase their resources by the reduction of loans, it is doubtful if Canada, despite the strength of its banking system in other respects, could escape from the losses caused by panic.

Solidarity or Unity of the System

The other feature making for financial ease in Canada, namely, the solidarity or unity of the banking system, is not easy to describe. It is a growth, a situation, rather than a creation of the law. When one has in view the protection of Canada's business and financial welfare; it is impossible not to regard the twenty-nine chartered banks, with their 2,200 branches, as a single institution. As lenders of money they are independent units. For that matter, the branch of each bank has a great deal of independence. All are independently seeking for deposits. Each branch is seeking to make the largest possible profit, and its manager is encouraging to the utmost the enterprises in his locality, for on the growth of the business he does depends his favor at headquarters. Nevertheless, from a national point of view, despite the competition among the banks and their branches, there is considerable reason for regarding the twenty-nine chartered banks of Canada as one institution.

Consider, for instance the following facts:

1. Over fifty per cent of the banking business in Canada is done by six banks. One of these, the Bank of Montreal, has assets exceeding twenty per cent of the total. Another, the Bank of Commerce, with head office at Toronto, has resources equal to thirteen per cent of the total.

2. The Bank of Montreal is the depositary of most of the government funds and among the people is commonly spoken of as the government bank.

3. The Bankers' Association, an organization created by law,

is a medium through which the best banking opinion finds authoritative expression. Through this association the banks keep advised of all pending legislation in any way affecting banking interests.

4. Bank managers are trained experts and each one has the expert's regard for a man who has had a wider experience or a better training than himself. As a result, no manager will venture far upon a policy which is regarded by his competitors as dangerous

5. All the banks are equally interested in the unbroken prosperity of the country. The managers of the six largest banks, each having charge of over a hundred branches are particularly watchful. They realize that speculative excesses in any part of the country will bring loss to them and must be discouraged.

6. On account of this mutual interdependence of the banks, no bank in Canada can hope to achieve success by striking out upon an absolutely independent policy, if such conduct is likely to meet with the disapproval of the banking fraternity. The business public, from which a new bank must get its support, has confidence in the management and judgment of the established institutions. A depositor may feel that he ought to get more than three per cent interest on his balance. He may complain that his bank does not give him credit enough, or that it is not liberal enough in its collections. Nevertheless he would be reluctant to give his account to a new institution or to any institution, whether old or new, if it were managed by men not in good standing with the leading bankers.

7. In their insistence on the rule that a man shall borrow from only one bank the banks have done more than appears on the surface to make their system a unit. If a merchant is refused credit at one bank, he finds it practically impossible to get help from any other. This rule certainly makes the twenty-nine banks of the Dominion, from the borrower's point of view, a single institution.

8 There is practical unanimity of opinion among bankers with regard to business conditions and the outlook. The managers of Canadian banks get their information with regard to the country's condition from the managers of branches. Since all know what is going on in every part of the country, it is not remarkable that all usually are very much in agreement for the sources of information of all are practically the same.[5] As a result, Canada has a "banker's

[5]During the writer's stay in Canada, in April, 1909, he talked with bankers in Montreal, Ottawa, Toronto, and Winnipeg. Everywhere he raised practically the same topics of conversation, and everywhere got practically the same answers.

opinion" with regard to the business situation, as distinguished from the "opinions of bankers" in the United States. In the latter country the bankers in the West are often in disagreement with the bankers in the East, and the eastern bankers are frequently in considerable ignorance of the conditions and events which are shaping the opinions of their western brethren. In Canada, with reference to questions of fact or actual conditions, one finds very seldom any difference of opinion among Canadian bankers. If there is excessive speculation in any part of the country, if a certain industry is suffering because of tariff changes in Europe, or because of a scarcity of raw materials, or if capital is being employed in an industry in amounts not warranted by the demand, or if there is the prospect of a light yield of any agricultural product, the bankers are among the first to get the information, and all of them have it.

Importance of the Banker

This unanimity among the bankers with regard to business conditions makes the individual banker a much more important person in Canada than he is in the United States. Business men there do not speak of him as a mere money lender. They look upon him as a man who has especial facilities for getting information about business and financial questions and whose opinion, therefore, is entitled to great respect. This is true not only of the general managers, who as a rule live in the large cities and are men past middle life, but is true as well of the managers even of the small branches. In every community the manager of a branch bank, especially if it is a branch of one of the half dozen largest institutions, occupies a prominent position and exerts a powerful influence in the shaping of business opinion. Not only does he send reports daily or weekly with respect to events of importance within his field, but he himself is constantly getting letters of advice from the head office. He is the one man in the community who is in touch with the business conditions of the Dominion or, for that matter, of the world. He may be a young man, but he has had a training in the methods of Canadian banking, and it is known that he would not

The managers at the head offices get daily reports and letters from their branch managers, and the head offices in their turn send out information to the branches. As a result the men in the banking business in Canada know more about the whole country than any other set of men. The files of one of the larger banks probably contain more valuable and more accurate information about the current events in Canada than can be found in the files of any newspaper.

occupy his position if his superiors did not have confidence in his judgment.

As a result of all these conditions working together, it may fairly be said that Canada possesses many of the advantages of a central bank. The employees of each bank, from general manager down to the office boy in the smallest branch, are busily occupied in doing their share toward increasing the bank's business and profits. Each is keenly on the lookout for an opportunity to establish a new branch in a promising young community, and each is doing its best to serve its customers and to gain new ones. But if a cloud appears on the horizon, if bad news comes from England with regard to Canadian investments, or if there is wild speculation in Wall street, the leading bankers get together, not formally, but informally, and as a result the Canadian banks become practically a unit in their attitude toward the common peril.

The Panic of 1907

The policy adopted by the Canadian banks at the end of 1906, and followed throughout the strenuous year of 1907, illustrates forcibly the solidarity of the banking system. All business men remember the feverish activity of 1906, the steady advance in prices of goods, the insatiable demand for money, and the high rates of interest everywhere prevailing at the end of the year. To the average man it seemed a period of boundless and unending prosperity. Railroads had not cars enough to haul the freight offered them and could not get them built fast enough. Manufacturers in the United States and in Canada had withdrawn their traveling salesmen because they already had orders for a year ahead.

In the United States a few of the leaders in industry and finance sounded a note of warning, but most men were too busy to hear it and most of the 10,000 bankers refused to believe it justified. As the decline in the market prices of securities began in January, a few bankers in New York City—those in closest touch with the financial needs of corporations and with the temper of foreign money markets—became convinced that serious times were ahead. Most of those men, knowing that a public expression of their apprehensions would do little good and might do harm, silently went about the business of strengthening their resources. Meantime 10,000 or more bankers throughout the country, wondering

why the stock market should be weak when the country was so prosperous, continued to make advances at high rates of interest to expanding enterprises. As a result, when the crash came in October, it is doubtful if more than ten per cent of the bankers in the United States were prepared for it, and for several weeks there was an almost universal suspension of specie payments and withdrawal of banking support from deserving borrowers.

Canadian Banks Were Prepared

In Canada there was no panic. For a year the leading Canadian bankers had been urging upon their customers the necessity for caution, and in their annual reports to the shareholders early in 1907 bank presidents and general managers had given notice that the phenomenal profits and business of the preceding few years could not be expected to continue much longer. Financial journals and editorial writers for the daily press, taking their cue from the bankers, had for months called attention to the strain upon the world's money markets and pointed out the necessity for conservatism, not only among the banks but among the promoters of new enterprises.

In January, 1907, there was only one opinion among bankers as to the financial situation. For several years the country's trade had been expanding by leaps and bounds. Immigrants had poured into the country from Europe and from the United States. New capital had come from England and the United States at the rate of $200,000,000 a year. The profits of industrial and commercial products had been large. In ten years bank loans and deposits had doubled. In short, Canada's prosperity had been even greater than that of the United States. The demand for capital had outrun the supply, and the strain upon the banking resources every bank manager knew had reached the danger point. Every one of them said this to their shareholders; the newspapers published their remarks, and business men throughout the Dominion knew not only that they ought to retrench, but that they must. They knew that they could get no help from the banks if they sought to enlarge their operations.

Gradual Contraction of Loans

It was impossible, of course, for the banks to call an immediate halt in the expansion of enterprise or in the use of their credit.

During 1906 the current loans in Canada had risen from $450,000,000 to $550,000,000, an increase of nearly twenty-five per cent. Any attempt on the part of the banks to bring this upward movement to a sudden termination would have ruined many a solvent concern. For five months, or until the end of May, the banks suffered it to continue, their loans during that period rising from $550,000,000 to $590,-000,000. Then began a gradual contraction and a steady increase in the cash reserve. Between June 1 and September 1 the total of their current loans in Canada declined $10,000,000. At the same time they strengthened their reserves by accumulating cash in their own vaults and by enlarging the amount of their funds on call in New York City. Canadian borrowers were treated with more consideration than those in foreign countries, as is shown by the reduction in current loans elsewhere from $36,000,000 to $23,000,-000 between February 1 and July 1. The banks appear to have endeavored to convert their time loans outside of Canada into call loans, having in view an increase in the amount of funds available for immediate use.

Between January 1 and September 1 there was a decline in the demand deposits from $192,000,000 to $160,000,000 and an increase in time deposits from $400,000,000 to $425,000,000, so that the total of deposits suffered very little diminution. After the first of September, however, deposits steadily declined until the end of the year; time deposits from $425,000,000 September 1 to $400,000,000 December 31. Demand deposits remained practically unchanged during this period.

By the first of September Canadian bank managers were evidently quite alive to the necessity for caution. Thereafter all the changes in their statements indicated a conviction on their part that the situation was precarious and that the banker's first duty is to preserve the solvency of his bank and take care of its regular customers. They knew that large sums would be demanded of them for the movement of the crops and were disposed therefore to take every precaution against weakness. The season was late and it was known therefore that there would be difficulty getting the crops to market, for the Canadian railroads, like those in the United States, were embarrassed by lack of equipment.

Call Loans Reduced in New York

When the crash came in New York and the Knickerbocker Trust Company suspended on the 22d of October, Canadian banks immediately adopted measures of self-protection. During the next two months the total of their call loans outside of Canada declined from $62,000,000 to $40,000,000. There was also a small reduction of their call loans in Canada. Their cash reserve was increased by $5,000,000. Their current loans in Canada, however, were $10,000,000 less November 30 than on October 1, and in December they fell off $15,000,000 more. These two months, November and December, were strenuous months in Canada as they were everywhere in the world. The western wheat crop was late and as a result there was a great clamor for funds for their movement. Currency was so scarce in the United States that Canadian bank notes disappeared over the border and performed their function as a medium of exchange in towns and country districts in the United States many miles distant from the Canadian line. Most of the banks found that their circulation was dangerously near the maximum and feared that they might be called upon to pay out legal tender. There was not the slightest suspicion of banks in Canada and no talk whatever of a run upon any bank. People did complain, however, that the banks were not doing their duty by the western farmers. Why should the banks be lending money on call in Wall street, when the farmers of Manitoba were unable to market their crops because buyers could not get funds from the banks?

Circulation Too Near The Limit

The banks, their deposits declining, their circulation near the maximum, the railroads unable to haul the crops promptly to market, dared not tie up funds in agricultural products which might later be called for by the commercial and industrial interests of the Dominion. If their capital had been larger so that they might have expanded their note circulation with impunity, the situation would have been less difficult. Yet something more than notes was wanted. For the first time in many years Canada felt the pinch of that want which is annually felt in the United States, namely, a sudden and great increase in the demand for both capital and currency. And for the first time they faced the risk of being

compelled to pay out legal tender money if they satisfied the demands of grain buyers. In other words, the Canadian banks and the agricultural interests of Canada during the last three months of 1907 had a taste of what the banks and farmers of the United States experience every year. The banks dared not make large advances to the buyers of grain lest the depletion of their reserves or an excessive issue of notes should result. The total circulation had climbed up to $89,000,000, which was only about $6,000,000 under the maximum, and no bank felt that it could authorize its branches to increase the issue of notes; the risk of being called upon to pay the penalty for excessive issue was too great.

To the Canadian banker and to his customer the situation was entirely new. Never before during this generation had the banks been obliged to restrict their loans merely because they feared that an excessive issue of notes might result. Serious and new as the situation was, and though it gave rise to many complaints in business circles, nevertheless there were no important business failures in Canada, and bankers in general felt confident that they would be able to bring the country safely through the crisis. In the last two months of the year the deposits declined $30,000,000 and the current loans in Canada $25,000,000. This shrinkage was inevitable. Many depositors having investments in the United States were obliged to protect them by the withdrawal of funds from Canada. The banks, on their side, were obliged to withdraw their assistance from such customers as needed it least. It is the boast of the banks, however, and is now generally admitted, that during these two months no man who actually deserved and needed a loan was refused it, and few borrowers were obliged to pay an unusual rate of interest.

The Government Tries to Help

Canadians are readers of the newspapers of the United States, and they know something about our habit of calling upon the government for aid whenever money is "tight." So the question was asked, Why should not the Dominion treasury come to our relief? The banks, it should be noted, did not ask this question. They did not believe that government aid was necessary. Nor was it evident how government aid could be afforded, for the Dominion treasury, unlike that of the United States, keeps all of its cash at

all times in the banks, and so has no reserve fund on hand on which to draw for the purpose of easing the money market. The government, however, was impressed by the popular demand and came forward with an offer of relief which involved a suspension of the Dominion legal tender act, similar to the suspension of the Peel bank act whereby the Bank of England has been permitted to issue notes unsecured by coin.

The issue was made upon the authority of the governor in council dated November 12, 1907, on a memorandum from the minister of finance, in which he described the effect of the world-wide monetary stringency upon Canada and declared that there was much anxiety in the West among farmers, traders, and bankers over "the prospect of insufficient financial accommodation to move the crop." He recommended that the minister be authorized to issue new Dominion notes and deposit them with the banks most largely interested in the grain business, and to accept from the banks high-class securities. In the second memorandum, dated November 26, he recommended that the advances be made through the Bank of Montreal, at such rates of interest, not less than four per cent per annum, as the Bank of Montreal might deem fair and reasonable. The advances were not to exceed $10,000,000 and were to be protected by the deposit of securities satisfactory to the Bank of Montreal. These issues of Dominion notes were approved by act of Parliament July 20, 1908. Events proved that the bankers were right in their claim that they were fully able to take care of the western situation, for there was a call for only $5,115,000 of this emergency issue of Dominion notes. The bankers understood the situation better than did the minister of finance.

The character of the year 1908 is shown by the bank returns. Current loans declined steadily from November 1, 1907, until March 1, 1909. Deposits, however, began to increase early in 1908, time deposits rising from $395,000,000, March 1, to $430,000,000, December 31. In the same period demand deposits increased from $140,000,000 to $210,000,000, while the cash reserve moved up from $75,000,000 to $100,000,000. The banks being unable to employ their idle funds in Canada during this year, put them out on call in the New York market. The item "call loans elsewhere" rose from $41,000,000, December 1, 1907, to $106,000,000, December 31, 1908, and by the end of May, 1909, had climbed to $125,000,000. This

is a much larger sum of money than the Canadian banks care to employ in the call-loan market.

During 1907 the banks gradually reduced the amount of call loans in Canada by about $11,000,000. The funds thus released were loaned to merchants, manufacturers, and the buyers of grain. In 1908 this item began to increase, the banks having more money than was needed by business interests. They adopted the same policy with current loans outside of Canada, reducing these during 1907 from $36,000,000 to $23,000,000. In 1908 this item began to increase.

Early in the year, 1907, in anticipation of a strain, the chartered banks began to increase the cash reserve, at the same time calling loans in New York and reducing foreign balances. Between May and October they loaned rather freely in the New York call-money market, but during October and November they reduced their outside call loans by $20,000,000. Their credit balances and call loans outside of Canada both increased greatly in the first seven months of 1908, when the demand for money was small in Canada. In the last quarter of 1908 the decline in foreign credit balances explains the rapid increase in outside call loans. Throughout 1909 the banks had resources beyond the needs of Canada, and the outside call loans rose to $138,000,000, an increase of nearly $100,000,000 in two years. In the same two years the cash reserve rose from $80,000,000 to $105,000,000, and the amount of securities held from $71,000,000 to $86,000,000. It is interesting to note that the amount of securities varied but little during 1907. It was not a good year for bonds.

Two Interesting Bank Failures

The story of banking is not without its dramatic incidents in any country. Canada has probably had fewer such incidents in the last generation than most countries, yet there was a bank failure in 1906 which furnished unique details. On the evening of October 12, the bankers of Toronto and Montreal heard with surprise that the Bank of Ontario had gone beyond its depth and would not open its doors the next morning. Its capital was $1,500,000 and its deposits $12,000,000. The leading bankers in the Dominion dreaded the effect which the failure of such a bank might have. The Bank of Montreal agreed to take over the assets and pay all the

liabilities, provided a number of other banks would agree to share with it any losses. Its offer was accepted and a representative of the Bank of Montreal took the night train for Toronto. Going breakfastless to the office of the Bank of Ontario he found the directors at the end of an all-night session and laid before them resolutions officially transferring the business and accounts of the bank to the Bank of Montreal. They adopted the resolution before nine a. m. and the bank opened business for the day with the following notice over its door: "This is the Bank of Montreal."

Before one o'clock the same notice, painted on a board or penciled on brown wrapping paper, was over the door of the thirty-one branches in different parts of the Dominion. Its customers were astonished that day when they went to the bank, but none of them took alarm and many of them were well pleased with the change. The note holders and depositors were paid in full, and it is generally understood that the venture was a profitable one for the Bank of Montreal, although litigation is still pending over the double liability of the stockholders. The general manager of the Bank of Ontario, who had sunk its capital in Wall street, received a five years' sentence for making false statements with regard to the bank's affairs.

First Outbreak of High Finance

Only one other large bank has been in trouble since 1890. It was the Sovereign Bank, an institution having over eighty branches and $16,000,000 in deposits. It was established in 1903 and was managed by an artist in "high finance," the only one of that class, it is claimed, who ever controlled a big Canadian bank. It is claimed that he was backed by large financial houses in New York and in Germany. He was reckless both in spending and in lending money, and early in 1907, when the assets amounted to over $25,000,000, it became known that much of its paper was valueless. The capital stock was reduced and a new management was placed in charge, but in January, 1908, the bankers of Toronto and Montreal were informed that the Sovereign would be obliged to suspend unless it received assistance. On the 18th of January its business was taken over by twelve banks which guaranteed the creditors against loss. The branches of the bank were divided among these twelve institutions, and report has it that some of the general managers were for a time unable to find all the branches that had been allotted to

them. The manager of the Sovereign, in his search for communities needing branch banks, had gone ahead of both map makers and the post office department. The assets of the bank are not proving equal to the liabilities, but the guaranteeing banks are protected from loss by the double liability of the stockholders.

The circumstances attending the liquidation of these two large banks certainly strengthen the view advanced in this chapter with regard to the solidarity or unity of the Canadian system. Bankers still shake their heads ruefully over the havoc wrought by the Sovereign and over the changes it made in banking practices, whereby various minor profits were annihilated, and declare that if another specialist in "high finance" appears among them they will let him and his friends take their medicine. "The banks can not go on forever," they say, "standing between the people and a rotten bank." Like the directors of the Bank of England, the presidents and managers of the big banks in Canada deny that any responsibility rests upon them for the protection of the country's financial security, yet when the next pinch comes the situation itself will compel them in self-defense to act together both quickly and effectively.

Since 1889 six small banks have failed, but note holders have lost nothing and depositors very little. They were local institutions with few branches and their failures possess little significance in a study of the banking system as a whole.

Conclusion

The Canadian banking system possesses features of extraordinary merit, adapting it admirably to the needs of the country which it serves. It performs most efficiently the service for which banks are created, gathering up the country's idle capital and placing it in channels of useful employment. The assets of the banks are of high quality because of protection afforded by the law and because borrowers are prevented by custom from hawking their paper through brokers. The law leaves the banks such freedom in the use of their credit that business is never brought to a halt through lack of instruments of exchange; whether the need be for checks and drafts or for bank notes, the supply is always adequate. The redemption system insures perfect elasticity for both the note and deposit currency. The reserve seems to be abundant for the

protection of the liabilities and to be composed of elements sufficiently liquid and available. Finally, on account of the extent to which the larger banks are interested in the trade and industries of all parts of the Dominion because of the investments made through their branches, the system possesses a solidarity that makes possible united action in the face of a common peril.